

## ***“Macro-Prudential Policies: Asian Perspectives”***

**October 18, 2010, Shanghai**

### **Session I: The Macro-prudential Framework<sup>1</sup>**

*This session will explore questions related to the analytical framework and institutional architecture that would govern and implement a new macro-prudential policy framework. The crisis has shown that focusing on the safety and soundness of individual institutions is not enough, and frameworks are needed to enable policies that take account of the systemic effects of institutions and markets. In other words, traditional micro-prudential policy frameworks need a macro-prudential overlay.*

#### **How should the objectives for macro-prudential policies be defined?**

Ultimately, the objective of macro-prudential policy is to ensure that a financial system can connect savers and investors so as to produce strong, stable, and well-balanced economic growth. Rather than focusing on the safety and soundness of individual institutions, the macro-prudential overseer is concerned with ensuring that the financial system is well-functioning, resilient, and does not behave procyclically. The challenges are: (i) to identify the systemic risk arising from financial institutions and their interactions, bilaterally and through markets; and (ii) to ensure that policies (both micro-prudential and macroeconomic) mitigate the tendency for system-wide vulnerabilities to build in good times in ways that translate into widespread financial sector losses and real economy stress in bad times.

#### **How should these objectives be integrated with the more traditional objectives for regulatory and macroeconomic policies, especially monetary policy?**

Traditional objectives for financial regulation include: financial stability; fair competition and a level playing field; and consumer protection. Monetary policy objectives are mainly price stability, low unemployment, and stable economic growth, although the weights attached to each of these objectives differ across countries. It will be necessary to examine whether and how monetary policy and financial regulation can meet the objectives of macro-prudential policies, which are to limit systemic risks and reduce procyclical tendencies in the financial system. It will, in particular, be necessary to consider how much weight should be

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<sup>1</sup> This section draws heavily on the analysis contained in a number of recent IMF publications, including Blanchard et al., “Rethinking Macroeconomic Policy,” IMF Staff Position Note 10/03 (<http://www.imf.org/external/pubs/ft/spn/2010/spn1003.pdf>) and Viñals et al., “Shaping the New Financial System,” IMF Staff Position Note 10/15 (<http://www.imf.org/external/np/sec/pr/2010/pr10376.htm>).

placed on traditional regulatory and macroeconomic objectives, and how much on macro-prudential objectives.

**Which agency should be given primary responsibility for financial stability (e.g., the micro-prudential overseer, the central bank, a council)?**

For the objectives of macro-prudential policies to be attained, responsibility and accountability for them need to be established. When multiple objectives are present and macro-prudential policies are aimed at multiple institutions and markets, the issue of whether an existing body is best placed or whether a new body needs to be set up arises.

In the case of micro-prudential regulation of financial institutions, there is no clear consensus on the best location and organization of responsibility. In practice, there are cases where supervisory responsibility is in the central bank, cases where there is a single regulatory body outside the central bank (the “twin peak” model), and cases where there are multiple (and sometimes overlapping) regulatory agencies and responsibilities.

In the case of macro-prudential responsibilities, the question becomes more difficult as the objectives may be more differentiated. For instance, if an overseer of systemically important financial institutions covers both banks and nonbanks, does the central bank have the expertise to cover the nonbanks (or even the banks)? Similarly, are the governance structures for the body given primary responsibility for macro-prudential policies consistent with its micro-prudential, macroeconomic, or other objectives? Can systemic liquidity support be combined with the monetary policy goal of low inflation or a monetary target? How would the accountability of various bodies be maintained—for instance, through reporting to a legislative body or publication of a public document?

These issues are actively being tackled in many countries. There appears to be a growing consensus on the need to assign primary responsibility to a single body that is accountable and responsible for ensuring systemic stability, has the instruments available to respond to emerging risks, and has the authority to effectively coordinate between other agencies. In some cases, the result has been to give the central bank greater responsibility and powers for both micro- and macro-prudential oversight. In some cases, financial system stability councils have been created to improve cooperation among agencies.

**How can macro-prudential policies be conducted and coordinated across national borders?**

The crisis showed that globalization works both to the benefit of all during good times, but interconnected and cross-border flows can act to compound problems during stressful times. Therefore, macro-prudential policies need to account for cross-border dimensions in their crisis management and prevention efforts, but they also need to avoid excessive diversity that could encourage regulatory arbitrage by financial and other firms or a “race to the bottom”

by regulators. Coordination in crises would also help avoid resorting to restrictions on cross-border financial flows transactions that could damage growth.

Work is underway by the Financial Stability Board (FSB), the BIS, and the IMF to establish frameworks for addressing macro-prudential issues in a cross-border context. The architecture for this new responsibility is still evolving, however, and will also need to consider the role of peer pressure to encourage countries to take appropriate account of the effect of their macroeconomic and macro-prudential policies on the broader system.

### **Issues for Discussion**

- What should be the objectives of macro-prudential oversight, e.g., mitigating procyclicality, assuring financial market stability, etc.? Could monitorable “intermediate targets” be defined to enable gauging success?
- How should macro-prudential objectives be linked to monetary policy objectives? Should the central bank be the institution to decide this relationship or should other bodies be involved?
- Where should a macro-prudential regulator be located? Within the central bank? Within a micro-prudential regulatory body? Should it be its own separate institution?
- What sort of governance structure should be set up to make sure the goals of macro-prudential policies are actually reached? Should there be regular reports to other parts of the government? To the public?
- How should the macro-prudential regulator relate to similar bodies in other countries? Should there be an international macro-prudential regulator? If so, how should it be made accountable to its members?